

Monetary policy statement by the Board of Governors of the Central Bank of Iceland

Policy rate remains unchanged

The Board of Governors of the Central Bank of Iceland has decided to hold the Bank's policy interest rate unchanged at 15.5%. Inflation rose sharply in the wake of the depreciation of the króna during the first months of the year and is now higher than the Bank forecast in April. According to the forecast published in this *Monetary Bulletin*, inflation will remain high into next year but decline rapidly thereafter. Lowering the policy rate later than was assumed in the last forecast will bring inflation to target at the time specified in April i.e. in Q3/2010.

As earlier Central Bank forecasts have shown, the outlook over the next two years is for a considerable contraction in GDP after a prolonged period of robust growth. That growth was not always sustainable, as is confirmed by the current account deficit. A contraction is therefore inevitable if equilibrium is to be restored.

Dwindling economic activity will better enable the Central Bank to contain inflation; however, the contraction will be a burden for many, particularly those who are most indebted.

The Central Bank is required by law to promote price stability. Many appear to think that the time is ripe to give greater consideration to the problems the credit crunch has caused in the economy and set other objectives aside, either temporarily or for the long term. At the present time, such efforts to stimulate the economy would have the opposite effect because they would precipitate a lower exchange rate, higher inflation, higher inflation expectations, and ultimately, a deeper economic contraction. They would weaken the balance sheets of indebted households and businesses and undermine financial stability.

In the coming months, it will be important to enhance confidence in the economy and effective market functioning. The Central Bank's swap agreements with Nordic central banks, its issuance of certificates of deposit, and the Government's plans for increased Treasury note issuance all contribute to the achievement of these goals and support the exchange rate of the króna. Iceland's commercial banks play an important role in maintaining confidence in the financial system. Under the current global financial market conditions, they must protect their liquidity and their capital position, seek all possible ways to reduce their need for foreign credit, and adapt the scope of their operations to dramatically changed circumstances.

Monetary policy is predicated on confidence, which takes a long time to build and consolidate. When adversity is at its peak, it is critical to stand fast and to adhere to the objectives that have been set. This is what the Bank intends to do so that it can begin to ease monetary policy with confidence when conditions permit it. As always, the most crucial task is to contain inflation and prevent the recent spurt

of inflation from causing a spiral of rising wages and prices and falling exchange rate. Real incomes will doubtless decline during the adjustment period, but that adjustment will be more transitory if these issues are addressed firmly. If these efforts are successful, it will be possible to expedite the reduction of the policy rate and the recovery of the economy. Monetary policy must provide the restraint that is required to reduce inflation and inflation expectations. Responsible parties must avoid undermining that restraint.